Monthly Newsletter
Savings and Investments
Still higher risk tolerance in markets

April 2016

Market overview

After a very weak start to the year, with sharply declining risk appetite, from mid-February we have seen a relatively powerful market rebound and higher risk appetite which continued through March as well. Equity markets around the world at the end of Q1 where close or slightly down to where they started the year. Fears related to China's slowdown, oil price plunge and downward revised economic growth started to ebb in the latter part of Q1, when we also saw more stimulus from the European Central Bank (ECB) and more cautious comments from the Federal Reserve (Fed). This has all helped to calm the markets down. Nevertheless, sentiment remains fragile, with investors continuing to worry about the uncertain outlook for global economic growth and corporate earnings. We still remain a bit more cautious, but our main scenario is still that the global economy will improve during the year.

Stock market performance*	Major events and expectations
USA (S&P 500 index, USD): **+6,6%** in March **+0,8%** YTD **+55,4%** in 5 years **Europe** (MSCI EURO, EUR): **+2,3%** in March **-7,3%** YTD **+12,2%** in 5 years **Eastern Europe** (MSCI EM Eastern Europe, USD): **+15,7%** in March **+14,9%** YTD **-53,4%** in 5 years **Asia** (MSCI EM Asia, USD): **+11,3%** in March **+1,7%** YTD **-13,4%** in 5 years **Latin America** (MSCI EM Latin America, USD): **+20,2%** in March **+18,5%** YTD **-53,2%** in 5 years	In **US sentiment was boosted** by hopes that the Fed would keep US **interest rates low for some** time yet. The Fed chair J. Yellen commented on a **challenging market environment** (primarily on uncertainty about growth in China and the risk if oil price continues to fall) and sent a clear message that an early rate rise is not on the agenda. Markets met it optimistically with expectations that the Fed would therefore keep interest rates lower for longer. SEB's forecast **two interest rate hikes** in September and December. J. Yellen highlighted the **strong US labor market and domestic demand**. The final US GDP growth figure for Q4 2015 was revised upward from a preliminary 1% annual rate to 1,4%, thanks to stronger private consumption. After a long period of weak signals from the **US manufacturing sector**, it finally **expanded** in March (Purchasing Managers' Index (PMI) 51,8, up from the February figure of 49,5). It is still too early to assess whether the manufacturing recovery is finally back on track, but the upswing in the forward-looking indicators like new orders suggests some further upside momentum. The **reporting season for the Q1 is starting**. There have already been major downward revisions of expected profits which **reduces the likelihood of negative surprises**. There are **no major changes in economy growth expectations** – the US economy is expected to grow above 2% this year and the world economy over 3% (more in monthly theme). In **Europe**, the **ECB** in March **unleashed his most audacious stimulus package yet** by cutting key interest rate as well as interest rate paid to commercial banks for depositing their cash with the central bank, also by expanding asset purchase programme (QE). The main focus by central bank is to spark inflation and boost economic activity in region. In March **inflation** in Eurozone stayed in **negative** territory (picked up to -0.1% from -0.2% in February), but **core inflation**, which strip out volatile food and energy prices, **increased** (picked up to 0,9% from 0.8%). This should ease some fears that low energy prices are feeding into the cost of other goods and services. But still, inflation remains far below the nearly 2% target of the ECB and brings struggle to revive the bloc's economy with a massive stimulus package. The **unemployment rate** has been **falling steadily in Eurozone** and in February hit 4,5 years low (10,3%), and purchasing managers' indices which show manufacturing activity remain consistent with steady growth. Overall, Eurozone's economy is improving (though very slowly), but remains vulnerable. Emerging markets performed strongly in March. In **China**, the latest macro data continues to show the economy **transforming from manufacturing and towards services and consumption**. The rate of economic growth is **slowing gradually**, but the economy is not collapsing. In Latin America, oil price increase and hopes of political change continued to **lift Brazil's stock markets**. **Russia's** energy-heavy stock markets **performed strongly** in March as crude oil price increased and by the end of March touched a three-month high on hopes of output cuts. However, stock market is very volatile and sensitive to oil price changes. **Oil prices** increased over USD 40/barrel in March, but dropped back to lower than USD 40 level in the beginning of April. Among underlying factors are statements and actions by Saudi Arabia attempting in various ways to persuade Iran not to boost its oil exports. **OPEC and non-OPEC producers will hold a meeting on April 17** regarding oil output freeze at January 2016 levels. Although SEB's analysts forecast an average Brent crude oil price of USD 40/barrel in 2016., they see a **risk of lower oil prices in the short term**.

* More information regarding indexes' performance can be found at the end of the document

Impact on investments of different risk categories

Product group	Impact during the last month and expectations looking forward
Low risk (conservative)	In March government bond yields continued to decrease mainly because of more stimulus from the ECB and more cautious comments from the Fed. Uncertainty factors and expansionary stimulus packages by central banks may keep the yields at lower levels for a while. On the other hand, stronger economic conditions may push them higher. Overall, the historically low interest rate climate is challenging for fixed income investments and we still have a negative view of government bonds, with US standing out as least attractive.
Medium risk (balanced)	The rebound in markets helped our balanced portfolios to generate positive results during the second half of Q1 2016, the values have recovered after loses in the first half of Q1. However, we still continue to stay at reduced risk level as we think that sharper market volatility will continue to persist for a while. In longer-term our main scenario is still that the global economy will improve and we can increase the risk any time. Investors started to come back in High yield (HY) bonds in the second half of Q1. Looking ahead from risk and return perspective HY bonds still seems to be the most attractive investment in bonds market. However, possible weaker global growth and low oil prices are factors causing concerns in HY market.
High risk (aggressive)	After a very weak start to the year, with sharply declining risk appetite, fears related to China's slowdown, oil price plunge and, downward revised economic growth started to ebb in the latter part of Q1, when we also saw more stimulus from the ECB and more dovish comments from Fed. This has all helped to restore some composure to markets. However, we still remain a bit more cautious, but our main scenario is still that global economic growth will accelerate during 2016, though at a slow pace. There is also potential for a more stable stock market trend, but we believe that volatility will come and go during the year. For example, we foresee a risk of continued volatility during the upcoming report season, with companies now needing to confirm that there is no need to revise earning expectations further downward.

SEB

Monthly theme

Growth, earnings and return

Several years of lower real economic growth and problems getting inflation to accelerate have made it more difficult for companies to increase their earnings. Furthermore, there are structural reasons that suggest we are also facing a period of low economic growth, low inflation and thus low nominal corporate earnings increases over the next couple of years. How will this affect expected returns and in what sectors and markets will we find the relative winners?

During the financial crisis of 2008/09, economic activity around the world collapsed and earnings plummeted. In the following years, central banks and governments made enormous efforts to stabilise the financial system, boost global growth and prevent deflation. This approach worked well until 2014, when we began to see increasing signs that neither growth nor inflation expectations were being met. The same is now true of aggregate corporate earnings growth. To understand these developments, it is important to distinguish between cyclical and structural drivers.

In recent years the economic trend has been divided, to say the least, with the "China effect" clearly having an adverse impact on cyclical elements of the global economy such as commodities and manufacturing. The fantastic environment that prevailed for many years, with enormous investment-driven growth in emerging markets and surging commodity prices, led to strong earnings but also large production capacity increases, which in recent years have had the exact opposite effect – falling prices and very weak earnings. This is an excellent example of structural effects. Meanwhile, in recent years we have had stable, strong growth in the service sector, which is explained by healthy real wage increases via low inflation and record-low interest rates as well as a favourable labour market. In this context, central bank moves to drive down interest rates around the world have had a strongly positive effect.

As a result of this dual-track economic situation in recent years, the total real growth rate (excluding inflation) has been modest. Over the next two years, we expect a somewhat higher earnings growth rate, but in a slightly longer perspective we believe structural forces such as demographics and productivity will have an adverse effect. This means that the more long-term real growth trend, which is adjusted for annual cyclical factors, is heading downward. A commonly held view is that we should expect growth to be half a percentage point lower going forward (compared to the forecasts in the table).

GDP (annual percentage change)	2015	2016	2017
United States	2,4	2,4	2,7
Japan	0,6	1,0	0,5
China	6,9	6,5	6,0
Euro zone	1,5	1,9	2,0
Sweden	3,6	3,7	2,8
The world (PPP*)	3,1	3,4	3,8

* PPP = Purchasing power parities; economies have been adjusted to account for price differences.

Earnings – what are they and how do they change?

When we look at the structure of corporate earnings, we can make the basic assumption that earnings equal revenue times profit margin. Over time, the interaction between these factors normally determines a company's profitability. However, other factors are involved, such as funding costs, extraordinary income and non-recurring costs.

Studying these fundamental factors, we can see that the revenue trend during the economic upturn of the past few years has been weaker than in many previous upturns – which means that GDP growth has not accelerated as much as in many earlier booms. This has been offset to some extent by rising productivity and cost saving programmes, which have boosted profit margins. In recent years, revenue has only risen marginally. The end result is that total earnings at the aggregate level are essentially unchanged.

While total earnings have largely stayed the same, we have seen an upturn in earnings per share. For example, in the S&P 500, this is explained by company share buybacks, which have been significant over the past three years. The fact is that earnings per share would have also trended negatively during that time if buybacks had been at a more historically normal level. Due to strong company balance sheets, conditions remain favourable for continued buybacks. The earnings per share metric can thus be propped up for another while.

How is lower projected trend growth reflected in expected returns?

With some kind of recovery expected in economic growth and inflation over the next two years, equities and corporate bonds should deliver higher expected returns than, for instance, government bonds, which show very low yields – one effect of modest inflation forces and central bank asset purchases. This is normal, of course, since investors expect compensation for taking a higher risk.

Should this trend become a reality, investors will continue to look for investment opportunities that can match what government bonds once delivered – stability as well as both nominal and real returns. More and more investors are currently trying to achieve this by locking in investments for a longer period (and thus earning higher yields as compensation) or by investing in companies that have high dividend yields or coupons through the stock or bond markets.

Another strategy is to look for companies that can generate much stronger than average earnings and that are preferably also less dependent on the business cycle in a "low everything" environment – with low inflation, low interest rates, low yields, low economic growth and low earnings growth. This strategy favours equity investments. So why have investors reduced their equity holdings in favour of government bonds and pure cash holdings in the past year? There are a number of reasons: valuations were high for a year in a historical perspective, there were serious concerns about the economy, and company earnings did not meet expectations.

Conclusion

The ever weaker nominal economic growth of recent years has structural causes; there is reason to assume slower growth in the next couple of years as well. This means that investors will probably have to lower their future earnings expectations. This has already had a significant impact on pricing in the capital market.

For the time being, this weaker growth has been partly overshadowed by general worries about economic growth and the earnings cycle, which have made investors far more cautious. Should it turn out that the economy nonetheless manages to generate decent growth, investors will look to the stock market and the corporate bond market in their search for returns. In these segments, growth-oriented companies will be attractive.

Sources: *SEB Investment Outlook, March 2016*

Terminology explanation

Terminology used	Explanation
Buyback	A buyback is the repurchase of outstanding shares on the market (repurchase) by a company in order to reduce the number of shares on the market. Companies will buy back shares either to increase the value of shares still available (reducing supply), or to eliminate any threats by shareholders who may be looking for a controlling stake.
Gross Domestic Product (GDP)	The monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.
Domestic demand	Total purchases of goods and services, regardless of origin, by country's consumers, businesses, and governments during a given period. Domestic demand equals gross domestic product minus net exports.
Investment grade bonds, high yield bonds	Investment grade bonds – bonds (sovereign or corporate) with credit ratings that indicate a relatively low risk of default. High yield bonds – bonds (sovereign or corporate) with credit ratings that indicate a relatively higher risk of default than investment grade bonds. Because of the higher risk of default, these bonds pay a higher yield than investment grade bonds. Two main credit rating agencies Standard & Poor's (S&P) and Moody's, use different designations consisting of upper- and lower-case letters 'A' and 'B' to identify a bond's credit quality rating. S&P designations of 'AAA' and 'AA' (high credit quality) and 'A' and 'BBB' (medium credit quality) are considered investment grade. Credit ratings for bonds below these designations ('BB', 'B', 'CCC', etc.) are considered low credit quality, and are commonly referred to as high yield or "junk bonds".
Nominal and real growth / return	The main difference between nominal and real values is that real values are adjusted for inflation, while nominal values are not, for instance: a) Nominal GDP growth – Inflation = Real GDP growth; b) Nominal investment return – Inflation = Real investment return. As a result, nominal GDP or investment return will often appear higher than real GDP or investment return (if there is no deflation).
Oil types: Brent and WTI	Brent Blend (Brent) and West Texas Intermediate (WTI) oil types are used as benchmarks for the prices of other crude oils. Roughly two-thirds of all crude contracts around the world reference Brent, making it the most widely used marker of all. These days, Brent actually refers to oil from parts of the North Sea off the coast of the U.K. and Norway (Brent, Forties, Oseberg and Ekofisk). Because the supply is water-borne, it's easy to transport to a distant locations. WTI refers to oil extracted from wells in the US (sent via pipeline to Cushing, Oklahoma). The fact that supplies are land-locked is one of the drawbacks to West Texas crude – it's relatively expensive to ship to certain parts of the globe. WTI continues to be the main benchmark for oil consumed in the US.
Organization of Petroleum Exporting Countries (OPEC)	An organization consisting of the world's major oil-exporting nations. OPEC was founded in 1960 to coordinate the petroleum policies of its members, and to provide member states with technical and economic aid. OPEC is a cartel that aims to manage the supply of oil in an effort to set the price of oil on the world market, in order to avoid fluctuations that might affect the economies of both producing and purchasing countries.
Purchasing managers' indexes (PMIs)	An indicator of the economic health of the manufacturing sector. The PMI indexes are based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment. A PMI of more than 50 represents expansion of the manufacturing sector, compared to the previous month. A reading under 50 represents a contraction, while a reading at 50 indicates no change.
Purchasing power	Purchasing power is the value of a currency expressed in terms of the amount of goods or services that one unit of money can buy. Purchasing power is important because, all else being equal, inflation decreases the amount of goods or services you would be able to purchase.
Purchasing power parity (PPP)	An economic theory that estimates the amount of adjustment needed on the exchange rate between countries so that an identical good has the same price when expressed in the same currency.
Quantitative easing (QE)	An unconventional monetary policy in which a central bank purchases government securities or other securities from the market in order to lower interest rates and increase the money supply. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.
Yield	The income return on an investment. This refers to the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value.

Stock market indexes performance information covering the immediately preceding 5 years till 31 March, 2016

Region	Index	Currency	Performance						
			2011	2012	2013	2014	2015	12 months	2016 YTD
USA	S&P 500	USD	0,0%	13,4%	29,6%	11,4%	-0,7%	-0,4%	0,8%
Europe	MSCI EURO	EUR	-16,5%	15,6%	19,6%	2,3%	6,1%	-16,9%	-7,3%
Eastern Europe	MSCI EM Eastern Europe	USD	-23,3%	13,2%	-2,9%	-40,0%	-8,1%	-4,8%	14,9%
Asia	MSCI EM Asia	USD	-19,1%	18,1%	-0,2%	2,5%	-11,8%	-14,6%	1,7%
Latin America	MSCI EM Latin America	USD	-21,9%	5,4%	-15,7%	-14,8%	-32,9%	-11,5%	18,5%